



KPMG LLP
SouthTrust Tower
Suite 1800
420 20th Street North
Birmingham, AL 35203

Independent Auditors' Report

The Public Education Employees'
Health Insurance Board:

We have audited the accompanying balance sheet of the Public Education Employees' Health Insurance Fund (a component unit of the State of Alabama) as of September 30, 2007, and the related statements of revenues, expenses, and changes in fund equity and cash flows for the year then ended. These financial statements are the responsibility of the Public Education Employees' Health Insurance Fund. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year partial comparative information has been derived from the Public Education Employees' Health Insurance Fund's 2006 financial statements and, in our report dated March 15, 2007, we expressed an unqualified opinion on such financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Public Education Employees' Health Insurance Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Public Education Employees' Health Insurance Fund (a component unit of the State of Alabama) as of September 30, 2007, and its changes in fund equity for the year then ended in conformity with U.S. generally accepted accounting principles.

The management's discussion and analysis on pages 2 through 4 and the claims development information on page 18 are not required parts of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

March 12, 2008

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Management's Discussion and Analysis

The Public Education Employees' Health Insurance Fund (PEEHIF) is a health insurance plan for active and retired employees' of state educational institutions. The contributions and benefit payments related to retirees that are processed through the PEEHIF are segregated from the PEEHIF and reported as part of the Alabama Retired Education Employees' Health Care Trust (Trust). In previous years, the financial report included active and retiree financial information. The following discussion provides an overview of the financial position and results of operation for the PEEHIF as of and for the year ended September 30, 2007, respectively. For more detailed information, please refer to the financial statements, including the Notes to the Financial Statements and the Required Supplementary Information.

Financial Statements and Required Supplementary Information

The financial statements include the Balance Sheet, Statement of Revenues, Expenses, and Changes in Fund Equity and the Statement of Cash Flows. The Notes to the Financial Statements are considered an integral part of the financial statements. The financial statements are prepared using the economic resources measurement focus and accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred, regardless of when cash is received or expended. Investments are reported at fair value.

Balance Sheet – Includes all assets and liabilities of the PEEHIF and provides a snapshot of the financial position of the PEEHIF as of the end of the fiscal year. Assets equal liabilities plus fund equity.

Statement of Revenues, Expenses, and Changes in Fund Equity – Reports all revenues and expenses of the PEEHIF for the fiscal year. Revenues include premiums, changes in the fair value of investments, and interest income. Expenses are principally made up of claims. Revenues minus expenses provide the income/(loss) for the fiscal year. Income/(loss) plus the beginning fund equity provides the fund equity at fiscal year-end.

Cash Flow Statement – Provides information about the cash receipts and cash payments of the PEEHIF during the year. The cash flow statement is divided into three sections – operating, investing, and noncapital financing activities. Also, a reconciliation of operating income to net cash provided by operating activities is presented. The PEEHIF had no activities related to capital and related financing during the fiscal year. The PEEHIF cash flow statement was prepared using the direct method, as required by GASB Statement Number 34. Under the direct method, major classes of receipts and payments are displayed. The net change in cash during the year plus the cash at the beginning of the year equals the cash at the end of the year.

The Notes to the Financial Statements include a description of the organization, a summary of significant accounting policies, a description of contract administrators including the methods in which fees are determined, credit risk disclosures for cash and investments, concentration of investments disclosures, securities lending disclosures, and disclosures concerning unpaid claims liabilities.

The Required Supplementary Information following the Notes to the Financial Statements provides information pertaining to claims development. A table is used to illustrate the ten-year historical trend information on how PEEHIF's earned revenues and interest income compare to related costs of claims and other expenses assumed by PEEHIF as of the year-end.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Management's Discussion and Analysis

Comparative Summary Statements

Summary Comparative Balance Sheet
As of September 30, 2007 and 2006

(Amounts in Thousands)

	<u>2007</u>	<u>2006</u>	<u>Variance</u>	<u>% Increase (Decrease)</u>
<i>Assets</i>				
Cash	\$ 2,208	\$ 1,080	\$ 1,128	104.44
Receivables	2,378	3,456	(1,078)	(31.19)
Investments	92,455	292,257	(199,802)	(68.37)
Deposits with Claims-Paying Agent	707	20,393	(19,686)	(96.53)
Total Assets	\$ 97,748	\$ 317,186	\$ (219,438)	(69.18)
<i>Liabilities</i>				
Payables	\$ 15,868	\$ 18,296	\$ (2,428)	(13.27)
Claims Incurred but not Reported	35,576	52,355	(16,779)	(32.05)
Total Liabilities	51,444	70,651	(19,207)	(27.19)
Fund Equity	46,304	246,535	(200,231)	(81.22)
Total Liabilities and Fund Equity	\$ 97,748	\$ 317,186	\$ (219,438)	(69.18)

Summary Comparative Statement of Revenues, Expenses, and Changes in Fund Equity
For the Fiscal Years Ended September 30, 2007 and 2006

(Amounts in Thousands)

	<u>2007</u>	<u>2006</u>	<u>Variance</u>	<u>% Increase (Decrease)</u>
<i>Operating Revenues</i>				
Premiums	\$ 834,345	\$ 1,022,078	\$ (187,733)	(18.37)
Interest Income	16,404	11,143	5,261	47.21
Net Increase/(Decrease) in Fair Value of Investments	452	(58)	510	879.31
Securities Lending Income	37	-	37	-
Total Operating Revenues	851,238	1,033,163	(181,925)	(17.61)
<i>Operating Expenses</i>				
Claims	632,270	845,221	(212,951)	(25.19)
Administrative	2,199	2,609	(410)	(15.71)
Total Operating Expenses	634,469	847,830	(213,361)	(25.17)
Operating Income	216,769	185,333	31,436	16.96
Transfer to Retiree Trust Fund	(417,000)	-	(417,000)	-
Fund Equity - Beginning of Year	246,535	61,202	185,333	302.82
Fund Equity - End of Year	\$ 46,304	\$ 246,535	\$ (200,231)	(81.22)

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Management's Discussion and Analysis

Financial Analysis

- Premiums receivable decreased as a result of more timely payment of premiums.
- Investments decreased as a result of transferring assets to the Trust.
- Deposits with Claims-Paying Agent decreased as a result of improved timing of the payments to the Claims-Paying Agent and the payment of claims.
- Interest receivable decreased as a result of a decrease in investments.
- Premiums and claims decreased as a result of the segregation of the premiums and claims related to retirees from the PEEHIF and reported as part of the Trust.
- The increase in fair value of investments was primarily due to market gains and from the sale of investments.

Financial Highlights

- The decrease in fund equity was a result of a transfer of \$417,000,000 from the PEEHIF to the Trust.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Balance Sheet

September 30, 2007 with comparative figures for 2006

(Amounts in Thousands)

	<u>2007</u>	<u>2006</u>
<i>Assets</i>		
Cash (Note 1)	\$ 2,208	\$ 1,080
Receivables		
Premiums	1,815	2,026
Interest	<u>563</u>	<u>1,430</u>
Total Receivables	<u>2,378</u>	<u>3,456</u>
Deposit with Claims-Paying Agent	707	20,393
Investments, at Fair Value (Note 4)	<u>92,455</u>	<u>292,257</u>
 <i>Total Assets</i>	 <u><u>\$ 97,748</u></u>	 <u><u>\$ 317,186</u></u>
 <i>Liabilities</i>		
Accounts Payable	\$ 16	\$ 12
Employee Benefits Payable	460	440
Reported Claims Payable (Note 5)	15,392	17,844
Claims Incurred but not Reported (Note 5)	<u>35,576</u>	<u>52,355</u>
 <i>Total Liabilities</i>	 <u><u>51,444</u></u>	 <u><u>70,651</u></u>
 <i>Fund Equity</i>		
Expense	1,723	621
Insurance	<u>44,581</u>	<u>245,914</u>
 <i>Total Fund Equity</i>	 <u><u>46,304</u></u>	 <u><u>246,535</u></u>
 <i>Total Liabilities and Fund Equity</i>	 <u><u>\$ 97,748</u></u>	 <u><u>\$ 317,186</u></u>

See accompanying Notes to the Financial Statements.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Statement Of Revenues, Expenses And Changes In Fund Equity
For the Fiscal Year Ended September 30, 2007 with comparative figures for 2006

(Amounts in Thousands)

	<u>2007</u>	<u>2006</u>
<i>Operating Revenues</i>		
Premiums	\$ 834,345	\$ 1,011,950
Medicare Part D Reimbursement	-	10,128
Interest Income	16,404	11,143
Net (Decrease)/Increase in Fair Value of Investments	452	(58)
Securities Lending Activities		
Securities Lending Income	960	-
Less Securities Lending Expenses:		
Borrower Rebates	917	-
Management Fees	6	-
Total Securities Lending Expenses	<u>923</u>	<u>-</u>
Net Income from Securities Lending Activities	<u>37</u>	<u>-</u>
<i>Total Operating Revenues</i>	<u>851,238</u>	<u>1,033,163</u>
<i>Operating Expenses</i>		
Claims (Notes 2 and 5)	632,270	845,221
Administrative	<u>2,199</u>	<u>2,609</u>
<i>Total Operating Expenses</i>	<u>634,469</u>	<u>847,830</u>
<i>Operating Income</i>	216,769	185,333
<i>Transfer to Retiree Trust Fund</i>	<u>(417,000)</u>	<u>-</u>
<i>Fund Equity</i>		
Beginning of Year	<u>246,535</u>	<u>61,202</u>
End of Year	<u>\$ 46,304</u>	<u>\$ 246,535</u>

See accompanying Notes to the Financial Statements.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Statement Of Cash Flows
For the Fiscal Year Ended September 30, 2007 with comparative figures for 2006

(Amounts in Thousands)

	<u>2007</u>	<u>2006</u>
<i>Cash Flows From Operating Activities</i>		
Receipts from Participants	\$ 834,556	\$ 1,010,622
Receipts from Medicare Part D	-	10,127
Payments to Suppliers	(424)	(999)
Payments to Employees	(1,751)	(1,463)
Claims Paid	<u>(631,815)</u>	<u>(871,515)</u>
<i>Net Cash Provided by Operating Activities</i>	<u>200,566</u>	<u>146,772</u>
<i>Cash Flows from Investing Activities</i>		
Interest from Investments	17,308	10,145
Purchases of Investments	(4,038,876)	(3,501,968)
Sales and Maturities of Investments	<u>4,239,130</u>	<u>3,345,883</u>
<i>Net Cash Provided/Used by Investing Activities</i>	<u>217,562</u>	<u>(145,940)</u>
<i>Cash Flows from Noncapital Financing Activities</i>		
Transfer to Retiree Trust Fund	<u>(417,000)</u>	<u>-</u>
<i>Net Increase in Cash</i>	1,128	832
Cash at Beginning of Year	<u>1,080</u>	<u>248</u>
<i>Cash at End of Year</i>	<u>\$ 2,208</u>	<u>\$ 1,080</u>
<i>Reconciliation of Operating Income to Net Cash Provided by Operating Activities</i>		
Operating Income	\$ 216,769	\$ 185,333
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Interest Income	(16,404)	(11,143)
Net Decrease/(Increase) in Fair Value of Investments	(452)	58
Net Income from Securities Lending Activities	(37)	-
(Increase)/Decrease in Assets:		
Premium Receivable	211	(1,328)
Deposit with Claims Paying Agent	19,686	(18,589)
Increase/(Decrease) in Liabilities:		
Accounts Payable	4	8
Employee Benefits Payable	20	138
Reported Claims Payable	(2,452)	(4,019)
Claims Incurred but not Reported	<u>(16,779)</u>	<u>(3,686)</u>
<i>Net Cash Provided by Operating Activities</i>	<u>\$ 200,566</u>	<u>\$ 146,772</u>
<i>Noncash Investing Activities</i>		
Unrealized Increase/(Decrease) in Fair Value of Investments	\$ 3	\$ (47)
(Decrease)/Increase in Interest Receivable	(867)	998

See accompanying Notes to the Financial Statements.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

**Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2007**

1) Organization and Summary of Significant Accounting Policies

A. General

The Public Education Employees' Health Insurance Fund (PEEHIF) was established in 1983 under the provisions of Act 83-455 of the Alabama Legislature to provide a uniform plan of health insurance for employees and retired employees of state educational institutions which provide instruction at any combination of grades K-14 (collectively eligible employees), and to provide a method for funding the benefits related to the plan. The four-year universities are eligible and may elect to participate in the plan. At this time, Jacksonville State is the only university that has elected to participate in the plan. Responsibility for the establishment of the health insurance plan and its general administration and operations is vested in the Public Education Employees' Health Insurance Board (PEEHIB). In accordance with the Governmental Accounting Standards Board (GASB), the PEEHIF is considered a component unit of the State of Alabama (State) and is included in the State's *Comprehensive Annual Financial Report*.

In order to comply with the reporting requirements as set out in GASB Statement 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, the contributions (employer, plan member and Medicare Part D Retiree Drug Subsidy) and benefit payments related to retirees that are processed through the PEEHIF are segregated from the PEEHIF and reported as part of the Alabama Retired Education Employees' Health Care Trust (Trust). In previous years, the financial report included active and retiree financial information.

The Public Education Employees' Health Insurance Plan (PEEHIP) offers a basic hospital/medical plan that provides basic medical coverage for up to 365 days of care during each hospital confinement. The basic hospital/medical plan also provides for physicians' benefits, outpatient care, prescription drugs, and mental health benefits. Major medical benefits under the basic hospital/medical plan are subject to a lifetime contract maximum of \$1,000,000 for each covered individual.

Also available through the PEEHIP is an option to enroll in a health maintenance organization (HMO) in lieu of the basic hospital/medical plan. The HMO generally provides the same coverage as the basic hospital/medical plan.

Optional plans which may be selected in addition to or in lieu of the basic hospital/medical plan or HMO include: Hospital Indemnity, Cancer, Dental, and Vision. The Hospital Indemnity Plan provides a per day benefit for hospital confinement, maternity, intensive care, cancer and convalescent care. The Cancer Plan provides a per day benefit for each hospital confinement related to cancer only. The Dental Plan covers diagnostic and preventive services as well as basic and major services based on reasonable and customary charges up to \$1,000 per year per person with dependent coverage (\$1,250 per year per person with employee coverage only). The Vision Plan covers annual eye examinations as well as the cost of either eyeglasses or contact lenses.

Act 2004-646 allows PEEHIP members to enroll in a supplemental coverage plan in lieu of coverage in the PEEHIP Hospital/Medical or HMO plans. The supplemental coverage plan provides secondary benefits to the member's primary coverage provided by another employer. Active and non-Medicare retiree members and their eligible dependents are eligible to participate in the PEEHIP Supplemental Coverage Plan. There is no premium. However, the

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements For the Fiscal Year Ended September 30, 2007

A. General, Continued

supplemental plan cannot be used as a supplement to the PEEHIP hospital/medical plan or state or local governmental plans administered by the State Employees' Insurance Board.

Code of Alabama 1975, Section 16-25A-4 provides the PEEHIB with the authority to amend the benefit provisions in order to provide reasonable assurance of stability in future years for the plan.

The State contributes a specified amount (the employer rate) monthly to each respective participating school system. Each participating school system must then pay the employer rate to the PEEHIF each month. That rate was \$717 per participant per month for 2007. In addition to the employer payments each month, the employee pays certain premium amounts. Participants should refer to the PEEHIP's contracts for a more complete description of the PEEHIP's provisions. During fiscal year 2003, the Legislature passed Act 2003-473 (effective October 1, 2003) which requires universities that do not participate in PEEHIP to pay the health insurance costs of its retirees to the PEEHIF.

The monthly employer premium established by the Legislature in the 2007 Budget was paid in accordance with the recommendation by the PEEHIP management. The recommendation was based on the determination made by the third party actuary.

The Teachers' Retirement System of Alabama (TRS) has been appointed as the administrator of the PEEHIF.

B. Basis of Accounting

The PEEHIF is a proprietary fund that operates under the accrual basis of accounting. The PEEHIF has elected to exercise paragraph 6 of Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting." Statement 20, paragraph 6, requires that all proprietary activities should apply all applicable GASB pronouncements as well as any Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure (CAP) issued on or before November 30, 1989, unless such FASB, APB, and CAP pronouncements conflict with or contradict GASB pronouncements. FASB pronouncements issued after November 30, 1989, even if they modify an applicable FASB, APB, or CAP pronouncement, are not applicable unless adopted by a GASB pronouncement.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements For the Fiscal Year Ended September 30, 2007

C. Cash

Cash consists of deposits held by the State Treasurer in the PEEHIF's name. Deposits are entirely insured by Federal depository insurance or protected under the Security for Alabama Funds Enhancement (SAFE) Program. The *Code of Alabama 1975* requires all State organizations to participate in the SAFE Program. The SAFE Program is a multiple financial institution collateral pool. The SAFE Program requires all public funds to be deposited in a financial institution designated by the State Treasurer as a qualified public depository. Each qualified public depository is required to pledge collateral in accordance with the rules established by the SAFE Board of Directors. In the event that a qualified public depository defaults or becomes insolvent and the pledged collateral is insufficient to satisfy the claims of public depositors, the *Code of Alabama 1975, Section 41-14A-9(3)* authorizes the State Treasurer to make assessments against the other qualified public depositories in the pool so that there will be no loss of public funds. Cash restricted for payment of administrative expenses at September 30 was \$2,198,467.

D. Expense Fund

The PEEHIB designated \$3,300,000 of premiums received to be used for the payment of administrative expenses.

The administrative costs incurred directly for the operation of the PEEHIF are paid from the expense fund. No indirect costs are allocated to the PEEHIF by the TRS.

E. Investments

The Board of Control of the PEEHIF has the responsibility and authority to invest and reinvest available funds, through the secretary-treasurer and investment committee, in bonds, mortgage-backed securities, mortgages, common and preferred stock, and other investment vehicles with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use. All plan assets are carried at fair value. U.S. agency obligations and corporate bonds are reported at the last reported sales price. Commercial paper is reported at cost, which approximates fair value. Generally, private placements are valued based on the selling price of similar investments sold in the open market. In those instances where there are no similar investments sold in the open market, an appraisal is performed to determine the fair value of the private placements.

F. Premiums

Premium revenue is recognized in the period in which the related coverage is provided. Premium payments that have not been received by the end of a coverage period are recorded as premium receivable. Likewise, premiums received before the month of coverage are recorded as unearned premiums.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements For the Fiscal Year Ended September 30, 2007

G. Medicare Part D

Medicare Part D reimbursements are the result of PEEHIP continuing prescription drug coverage for Medicare beneficiaries and qualifying for the Medicare subsidy. In order to comply with GASB Statement 43, Medicare Part D reimbursements are now reported in the Trust.

H. Transfer to the Retiree Trust Fund

The PEEHIB authorized a transfer of \$417,000,000 to the Trust which included the Medicare Part D reimbursements.

I. Unpaid Claims Liabilities

Claims liabilities are established based on the actual cost of claims reported but not settled, and estimates of claims that have been incurred but not reported. Actual claims costs ultimately incurred may vary from estimated claims liabilities should the nature and frequency of actual claims vary from historical claims experience on which the estimates are based. Adjustments to claims liabilities are charged or credited to expense in the periods in which they are made.

J. Employee Benefits

The PEEHIF records a liability and charge to expense for all compensated absences attributable to services already rendered and that are not contingent on specific events outside the control of the employer or employee.

K. Equity

Expense equity is allocated for the payment of administrative expenses. Insurance equity is allocated for the payment of insurance benefits.

L. Comparative Statements

The basic financial statements include the prior year Balance Sheet, Statement of Revenues, Expenses and Changes in Fund Equity, and Statement of Cash Flows (Statements) for comparative purposes only. Prior year Note Disclosures are not included. Therefore, the prior year basic financial statement presentation does not meet the minimum level of detail required for a presentation in conformity with generally accepted accounting principles. Accordingly, the prior year Statements should be read in conjunction with the PEEHIF's prior year financial report from which the prior year Statements were derived.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements For the Fiscal Year Ended September 30, 2007

2) Contract Administrators

Blue Cross and Blue Shield of Alabama (BCBS), under contract with the PEEHIB, administered medical claims incurred in accordance with the plan. The BCBS administrative fee was \$8.00 per month per contract subject to a maximum of 2.55 percent of paid claims. The \$8.00 per member per month fee was charged to the PEEHIF.

Express Scripts, Inc., under contract with the PEEHIB, administered claims under the prescription drug plan. Express Scripts administrative fee was \$.74 per prescription. Certain additional fees are based on specific services directed by PEEHIP. The \$.74 per prescription fee was charged to the PEEHIF.

Southland National Corporation (Southland), under contract with the PEEHIB, administered claims under the optional plans. The PEEHIF paid Southland an amount equal to covered charges plus processing fees. The processing fees per month per contract were \$.80 for Group Hospital Indemnity, \$.65 for Group Cancer, \$1.15 for Group Vision, and \$1.49 for Group Dental.

3) Facilities

The PEEHIF operates in facilities provided at no cost by the Retirement Systems of Alabama.

4) Investments

A. Investment Risks

Investments are subject to certain types of risks, including interest rate risk, custodial credit risk, credit quality risk, and foreign currency risk. The following describes those risks:

Interest Rate Risk – The fair value of fixed-maturity investments fluctuate in response to changes in market interest rates. Increases in prevailing interest rates generally translate into decreases in fair value of those instruments. The fair value of interest sensitive instruments may also be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, and other general market conditions. Certain fixed maturity investments have call provisions that could result in shorter maturity periods. However, the Fund's intent is to hold all fixed maturity investments until maturity, and as such, fixed maturity investments are classified in the following tables as if they were held to maturity.

Custodial Credit Risk – For an investment, custodial credit risk is the risk that an entity will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party if the counterparty fails. The PEEHIF's custodial credit risk policy requires the custodial agent to hold or direct its agents or subcustodians to hold, for the account of the PEEHIF all securities and other non-cash property other than securities in the Federal Reserve book-entry system, in a clearing agency which acts as a securities depository, or in another book-entry system. The PEEHIF's safekeeping agent holds all investments of the PEEHIF in the PEEHIF's name.

Credit Quality – Nationally recognized statistical rating organizations provide ratings of debt securities quality based on a variety of factors, such as the financial condition of the issuers, which provide investors with some idea of the issuer's ability to meet its obligations. Domestic fixed-maturity investments may consist of rated or non-rated securities. International fixed-

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements For the Fiscal Year Ended September 30, 2007

A. Investment Risks, Continued

maturity investments may consist of securities with a rating of at least A by one of the principal rating agencies at the time of purchase or acquisition, except that up to 2% of the fair value of the Fund's total portfolio may be invested in obligations of sovereign countries with a rating of BBB or BAA at the time of purchase. The Fund may hedge against the possible adverse effects of currency fluctuations on the Fund's portfolio of international fixed income obligations when it is considered appropriate. Short-term investments may consist of commercial paper rated at least A-2 and/or P-2, repurchase agreements, short-term U.S. securities, and other money market investments.

Foreign Currency Risk – The risk that changes in exchange rates will adversely affect the fair value of an investment. In order for an international equity security to be eligible for purchase by the Fund, the issuing company must be incorporated in a country whose debt securities are eligible for purchase as discussed above, and the market value of the aggregate outstanding equity of the issuing company must be at least \$100 million.

Concentration of Credit Risk – The investment policies limit the aggregate amount that can be invested in each class of investments. The policy limits are as follows:

- **Domestic Fixed Income** – Limited to 100% of the fair value of the aggregate portfolio for the Fund.
- **International Fixed Income** – Limited to 10% of the fair value of the Fund's total portfolio.
- **Domestic Equity** – Limited to 65% of the fair value of the Fund's aggregate portfolio.
- **International Equity** – The aggregate fair value of international equities is limited to 25% of the aggregate fair value of the Fund's total portfolio. Also, the Fund may not purchase or hold more than 5% of any class of the outstanding stock of a company.
- **Real Estate** – The suggested limit is 15% of the book value of the Fund's portfolio.
- **Alternative Investments** (mezzanine financing, LBO's, venture capital, limited partnerships, futures, commodities and derivative investments) – Limited to 10% of the book value of the Fund's aggregate portfolio.
- **Short-term Investments** – Limited to 100% of the fair value of the Fund's aggregate portfolio in order to maintain adequate liquidity for payment of member health care benefits.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2007

A. Investment Risks, Continued

The following table provides information as of September 30, 2007, concerning the fair value of investments and interest rate risk:

INVESTMENTS

(Amounts in Thousands)

Type of Investment	Maturity in Years at Fair Value				Total Fair	
	Less			More		
	Than 1	1-5	6-10	Than 10	Value	Cost
Commercial Paper	\$ 33,997	\$ -	\$ -	\$ -	\$ 33,997	\$ 33,997
Private Placements	-	501	-	-	501	448
Money Market Funds	57,957	-	-	-	57,957	57,957
Total Investments	\$ 91,954	\$ 501	\$ -	\$ -	\$ 92,455	\$ 92,402

The following table provides information as of September 30, 2007, concerning credit risk:

RATINGS OF FIXED MATURITIES

(Amounts in Thousands)

Moody's Ratings	Fair		Fair Value as a %
	Value	Cost	of Total Fixed Maturity Fair Value
AA3	\$ 501	\$ 448	0.542
P-1	57,957	57,957	62.687
P-2	33,997	33,997	36.771
Totals	<u>\$ 92,455</u>	<u>\$ 92,402</u>	<u>100.000</u>

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements For the Fiscal Year Ended September 30, 2007

B. Concentration of Investments

As of September 30, 2007, the PEEHIF owned debt securities of Gatz Financial Corporation, Computer Sciences Corporation, and Detroit Edison Company, which represented approximately 16.22%, 10.82%, and 5.41%, respectively, of the total fair value of investments.

C. Securities Lending Program

The PEEHIF is authorized to participate in a securities lending program. The Fund's custodian, State Street Bank and Trust Company, administers the program. Certain securities from the Fund are loaned to borrowers approved by the Fund. Approved borrowers of securities provide acceptable collateral in the form of cash, securities issued or guaranteed by the United States government or its agencies or instrumentalities, sovereign debt, Canadian Provincial debt, convertible bonds, irrevocable bank letters of credit by a person other than the borrower or an affiliate of the borrower if State Street determines to be appropriate, and such other collateral as the parties may agree to in writing from time to time. All security loans are open loans and can be terminated on demand by the Fund, or borrower. The initial collateral received shall have (i) in the case of loaned securities denominated in United States Dollars or whose primary trading market is located in the United States, sovereign debt issued by foreign governments (other than Canada) or corporate bonds that are not denominated in United States Dollars (other than those issued in Canada), a value of 102% of the fair value of the loaned securities, or (ii) in the case of loaned securities which are not denominated in United States Dollars or whose primary trading market is not located in the United States (and are not referenced in (i)), a value of 105% of the fair value of the loaned securities, or (iii) in the case of loaned securities comprised of UK gilts, a value of 102.5% of the fair value of the loaned securities, or (iv) in all other cases, such value, not less than 102% of the fair value of the loaned securities, as may be applicable in the jurisdiction in which such loaned securities are customarily traded. Pursuant to the terms of the applicable securities loan agreement, State Street shall, in accordance with State Street's reasonable and customary practices, mark loaned securities and collateral to their fair value each business day based upon the fair value of the collateral and the loaned securities at the close of the business employing the most recently available pricing information and receive and deliver collateral in order to maintain the value of the collateral at no less than 100% of the fair value of the loaned securities.

The PEEHIF cannot pledge or sell collateral securities received unless the borrower defaults. Cash collateral is invested in the State Street Global Securities Lending Trust (SSGSLT).

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2007

C. Securities Lending Program (Continued)

The following describes the SSGSLT's fund guidelines. The SSGSLT invests non-qualified cash collateral from loans of securities. Its average effective duration is restricted to 120 days or less. The maximum remaining effective maturity of any instrument is five years. At the time of purchase all securities with maturities in first-tier securities and all securities with maturities in excess of 13 months will be rated A or better by at least two nationally recognized statistical rating organizations (NRSROs), or, if unrated, be of comparable quality. The Fund may invest in other State Street managed investment vehicles provided they conform to fund guidelines. The SSGSLT's guidelines allow for its management as an enhanced cash vehicle. Additionally, all debt instruments purchased by SSGSLT must have been issued after July 18, 1984, in order to meet IRS Code Sections 871 and 881.

Cash collateral investments in the SSGSLT are matured as needed to fulfill loan obligations. There is no direct matching of the maturities of the loans with the investments made with cash collateral.

Since there were no outstanding loans at September 30, there was no credit risk exposure as of September 30, 2007. There were no significant violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior period losses during the year.

Investments purchased with cash collateral are held by the custodial agent, but not in the name of the PEEHIF. Securities pledged as collateral are held by the custodial agent, but not in the name of the Fund. Letters of credit pledged as collateral are issued by the borrower's bank and are irrevocable.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2007

5) Unpaid Claims Liabilities

As discussed in note 1, the PEEHIB establishes a liability for both reported and unreported insured claims, which includes provisions for both future payments of losses and related claim adjustment expenses. The following represents changes in those aggregate liabilities for the PEEHIF for 2007.

UNPAID CLAIMS LIABILITIES

(Amounts in Thousands)

Unpaid Claims and Claim Adjustment Expenses at Beginning of Year	\$ 70,199
Incurred Claims and Claim Adjustment Expenses:	
Provision for Insured Events of the Current Year	636,854
Decrease in Provision for Insured Events for Prior Years	<u>(4,584)</u>
Total Incurred Claims and Claim Adjustment Expenses	<u>632,270</u>
Payments:	
Claims and Claim Adjustment Expenses Attributable to Insured Events of the Current Year	585,303
Claims and Claim Adjustment Expenses Attributable to Insured Events of the Prior Years	<u>66,198</u>
Total Payments	<u>651,501</u>
Total Unpaid Claims and Claim Adjustment Expenses at the End of the Year	\$ <u>50,968</u>

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Required Supplementary Information

Claims Development Information
(Amounts in Thousands)

The table below illustrates the ten-year historical trend information designed to provide information on how PEEHIF's earned revenues and interest income compare to related costs of claims and other expenses assumed by PEEHIF as of year end. The lines of the table are defined as follows: (1) This line shows the total of each fiscal year's earned contribution revenues and investment revenues. (2) This line shows each fiscal year's other operating costs of PEEHIF including overhead and claims expense not allocable to individual claims. (3) This line shows PEEHIF's incurred claims and allocated claim adjustment expense (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred (called policy year). (4) This line shows the cumulative amounts paid as of the end of successive years for each policy year. (5) This line shows how each policy year's incurred claims increased or decreased as of the end of successive years. This annual reestimation results from new information received on known claims, reevaluation of existing information on known claims, as well as emergence of new claims not previously known. (6) This line compares the latest reestimated incurred claims amount to the amount originally established (line 3) and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for each policy year matures, the correlation between original estimates and reestimated amounts is commonly used to evaluate the accuracy of estimated incurred claims currently recognized.

	Fiscal and Policy Year Ended									
	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
1) Net Earned Required Contribution & Investment Revenue	851,238	1,033,163	873,373	718,716	634,410	595,952	521,723	477,884	413,669	360,343
2) Unallocated Expenses	2,199	2,609	3,343	1,261	1,026	974	984	937	963	860
3) Estimated Incurred Claims & Expense, End of Policy Year	636,854	858,906	802,624	743,387	669,578	585,644	513,357	481,794	423,521	366,970
4) Paid (Cumulative) As Of: End of Policy Year	585,303	788,707	724,720	652,929	596,616	521,678	457,395	428,698	369,264	329,040
One Year Later	-	854,905	788,939	725,418	661,598	582,643	508,555	476,493	418,498	366,395
5) Reestimated Incurred Claims & Expense: End of Policy Year	636,854	858,906	802,624	743,387	669,578	585,644	513,357	481,794	423,521	366,970
One Year Later	-	854,322	788,939	725,418	661,598	582,643	508,555	476,493	418,498	366,395
6) Increase (Decrease) in Estimated Incurred Claims & Expenses End of Policy Year	-	(4,584)	(13,685)	(17,969)	(7,980)	(3,002)	(4,802)	(5,301)	(5,024)	(575)

This was the first year that retirees were segregated from the active employees. As a result, the current year includes the amounts only attributable to the active employees. This schedule will be presented prospectively.